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CURRENCIES AND CREDIT MARKETS

No. 233 / September 1992

"The final outcome of the credit expansion is general impoverishment. Some people may have increased their wealth . . . But the immense majority must foot the bill for the malinvestments and the overconsumption of the boom episode."

Ludwig von Mises, Human Action, 3rd Edition, 1986 p.564
Contemporary Books, Chicago

HIGHLIGHTS

The world economy is in the worst recession and financial crisis since the 1930s. The most ominous symptom is a worldwide collapse in private credit and broad money growth.

Despite the gravity of world economic conditions, few economists worry about the risk of a further deterioration or an impending crisis. They rest assured in the presumptuous notion that the disaster of the Great Depression can never be repeated.

It's time that we present a detailed analysis of the conditions in the 1920s that led up to the Depression. Also, we compare the relative size of the excesses of the 1920s with the 1980s.

Our review should shatter the satisfied complacency of today's policymakers and economists. Not only are the parallels strong, the comparisons makes the 1920s look like a tea party.

Yet, why do forecasters continue to forecast recovery and prosperity? They have succumbed to the "mind cult" of econometric computer models. The problem is that the models are constructed on an ill-fitting premise — the typical, short-term, postwar inventory recession.

We draw some contrasts between the economic thought of today and the 1920s and also the Austrian and the American schools. What we see now is an outright intellectual bankruptcy.

In the United States, Japan and Britain, broad money growth has fallen below nominal GNP growth for the first time. That bodes ill, particularly for their asset markets.

All of the "bubble" economies are experiencing a progressive impoverishment as a result of overconsumption, malinvestment and soaring foreign debts. The day of reckoning for some of their currencies has begun. The rest should soon follow.

If credit and money matters, as we think, the worst of the world recession is yet to come. Try as they might, we doubt that the governments and the central banks can do very much about the deepening worldwide economic and financial crisis.

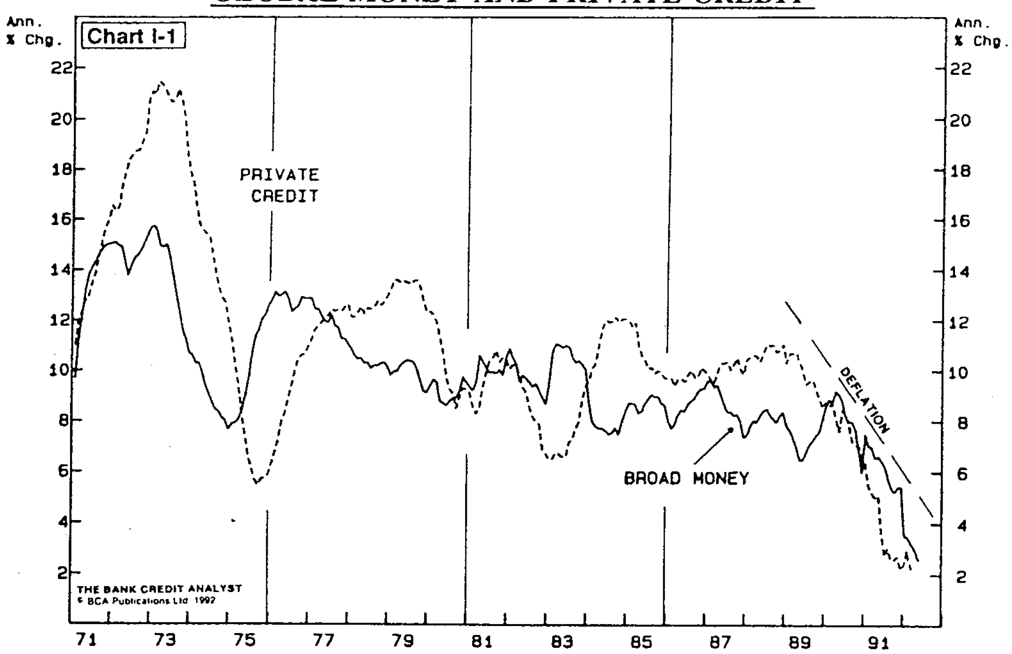
We continue to counsel investors to pursue the most conservative of investment strategies. We see high risks almost everywhere. For the long-run, government bonds of the hard currency countries — Switzerland and Germany — remain the most attractive.

SPREADING CRISIS: DOLLAR, STERLING . . . WHAT NEXT?

Without a doubt, the world economy is in the worst recession and financial crisis since the 1930s. By far, the most significant and ominous symptom is a worldwide collapse in private credit and broad money growth. The epicentres of these rumblings are found in the "bubble" economies; their weakness is now rapidly spreading to the rest of the world. The unfolding money and credit crunch — unprecedented in its breadth and severity — first surfaced in the United States in 1988 and quickly spread to the rest of the world by mid-1990.

Deflation has taken over on the global scene; it's gaining momentum. Japan's broad money supply growth is down to a record-low ebb of only 0.2% year-over-year. U.S. broad money growth in recent months has even entered negative territory. As the following graph clearly shows, world money growth has dropped off to the lowest pace since the 1930s. If credit and money matters, as we think, the worst of the world recession is yet to come.

GLOBAL MONEY AND PRIVATE CREDIT*



Source: Bank Credit Analyst, August 1992 * GNP-weighted sum of Canada, Germany, Japan, U.K. and U.S.

GAUGING THE DEPTHS OF RECESSION

The length and severity of a recession or depression always depends on two different sets of influences: partly on the magnitude of the imbalances and maladjustments that may have built up in the economy and its financial system during the preceding boom and partly on the fiscal and monetary policies that follow after the boom is over. As bad as the preceding maladjustments may have been, inept and misguided policies always stand to make things worse.

Belatedly, it's been recognized that the current recessions in the United States, the UK, Canada and elsewhere differ fundamentally from the normal short-term cyclical patterns of the postwar period. Again and again, recovery forecasts have all gone horribly awry. Despite these sobering experiences

we still don't see any serious effort on the part of policymakers and the international forecasting fraternity to undertake a thorough reappraisal of the situation. All that's been offered so far is yet another rendition of the stereotypical assurance that "*recovery conditions are in place.*" We read that baleful phrase almost everywhere. The essence of the argument, essentially, is that a recovery is simply postponed. In reality, most forecasters don't have the faintest idea why this recession is so persistent and what the proper "*recovery conditions*" under present circumstances should really be.

What's the problem with these forecasters? They are slaves to the "mind cult" of econometric computer models. All of these models have been finely designed to capture the symptoms and internal relationships of the typical, short-term, postwar inventory recession. Based on this relatively short history, they assume that all recessions must unfold in a similar fashion. And so, their uncomprehending electronic boxes have been cranking out empty promises of recovery even while the economies remain locked in a declining trend. Why? Because we are dealing with a totally different type of recession. All of the crucial factors are completely unique. And that also explains why the economic downturns were never forecast in the first place.

More than just a computer is required to understand the present economic and financial muddle. What's needed is a knowledge of theory and history that helps to identify underlying causal connections and their wider implications. Unfortunately, those are things that the present generation of economists has hardly learned.

ECONOMIC ARROGANCE BEFORE THE FALL

A common and comforting opinion held by many economists is that the policy mistakes of the 1920s and 1930s can never be repeated because today's policymakers and economists have become vastly more enlightened. In their view, comparing today's economic expertise with that of 50 years ago is the medical equivalent of comparing microsurgery to medieval bloodletting. We couldn't disagree more vehemently. We're very familiar with the economic debates that dominated the 1920-30s period. Economic thought was on a much higher intellectual plane then. Today, theorizing and thinking have been largely replaced by mechanical number crunching. The resulting vacuum of theory even reaches the highest places. Just witness the frightening ignorance of today's central bankers that's revealed in their flawed explanations and interpretations of the collapse of broad money growth in the "bubble" economies. What we see is outright intellectual bankruptcy.

We think, in fact, that the Great Depression is highly relevant to current economic conditions. All our warnings about the impending disastrous consequences that would beset the many countries that indulged in all of the excesses of the past years, have been greatly influenced and stimulated by our thorough study of what happened in the United States and Europe before and during the Great Depression. Very few people seem to realize that the offending financial excesses of the 1980s — mainly debt orgies stimulated by asset inflation — were virtually the mirror image of the boom-time excesses in the 1920s.

THE GLOBAL DEPRESSION OF THE 1930s REVISITED: THE LEAD-UP

Back in the 1920s and 1930s, it was the United States and Germany that experienced the worst of the Great Depression. Rightly, therefore, most historical analysis has centred on these two countries. Even though both fared so badly, their economic calamities originated in totally different causes occasioned

by totally different excesses in the preceding boom.

The dominant feature of the U.S. boom in the 1920s was a runaway credit inflation. Crucially, and in variance from the normal pattern, the excess liquidity generated by the credit inflation vented itself in a speculative boom in stocks, real estate and capital exports. No other country during that time even came close to matching the scale of U.S. international lending.

Holding companies and investment trusts sprang up like mushrooms overnight, operating mostly on borrowed money. Leveraged trusts purchased other leveraged trusts while individuals bought these and other shares on margin financed by brokers' call loans. In this way, a credit "house of cards" was erected on Wall Street. At the time of the stock market crash in October 1929, call loans extended by brokers totalled $9.5 billion. While that figure may seem insignificant in today's terms, it was an enormous amount compared to the total $39 billion in commercial bank loans outstanding then.

Americans weren't content to just speculate in their home markets; they took the lead in an international lending mania, too. European and South American countries, elated with this easy credit, were actively soliciting capital "hat in hand." With its booming capital markets and soaring capital outflows, America spread its unhealthy domestic boom to the many other countries that eagerly participated. America's asset inflation washed up on many foreign shores to the delight of investors everywhere.

The topic of America's capital outflows brings us to the other major feature of the 1920s' boom and its important parallel with the 1980s: unusually large current-account (savings) imbalances between countries associated with an international lending and borrowing binge. It always takes two to cause a binge — a debtor and a creditor. It was Germany then that led the folly on the debtor's side. It managed to pile up an unprecedented mountain of foreign indebtedness.

If the amounts involved were insane, what was even greater lunacy was the uses to which the debtor countries put their borrowed foreign funds. Very little went into productive investment. The greater part simply financed rising living standards, excessive opulence and the overvaluation of assets. All in all, the international lending boom created an illusion of stability and prosperity that did not exist. As long as the flows continued, the cracks in the international economic structure were concealed. Yet, at the same time, reckless lending and borrowing served to widen the cracks. Ultimately, it was the drying up of these fund flows that contributed so powerfully to the world economic collapse.

In Germany's case, most of the money borrowed abroad was dissipated through war reparations and public deficits. What made the mix so vulnerable was the short-term nature of the international interbank credits which formed the basis of the excessive domestic credit expansion. In the short period between 1925 and 1928, Germany accumulated net foreign debts equivalent to about 15% of GNP. Today, by the way, the foreign debts of some of the Anglo countries greatly exceed this level!

This international lending pyramid suffered its first jolt during the course of 1928 when the U.S. stock market boom and rising U.S. interest rates curtailed U.S. capital outflows. This abrupt decline in capital outflows immediately created difficulties in the debtor countries. Later, in 1931, as the depression gathered momentum, the world economy was battered by a virtual collapse of international credit.

While the Great Depression of the 1930s surely had a whole variety of causes, two events were

undoubtedly the crucial triggers: the bursting of the internal U.S. asset price bubble and the collapse of the international financial system. Both were interrelated, and both were inevitable. Better monetary and fiscal policies after 1929 might at best have softened the downturn somewhat, but basically, the decline was largely predetermined in each country by the specific nature of the excesses in the preceding boom. Neither the U.S. asset inflation nor the international lending boom could go on forever. On the other hand, the countries which had not participated so much in the prior excesses — England, for example — fared much better in the downturn.

The U.S. economy plunged in 1929-30 when the inflated asset price bubble finally burst, leaving over-indebted consumers and a fragile banking system hopelessly extended. The German economy toppled when the capital inflows ceased and reversed into outflows.

A CONFLICTING DIAGNOSIS OF THE GREAT DEPRESSION

Curiously, American and German thinking about the causes of the Depression took diametrically opposite directions. The points of difference between these two bodies of opinion have important implications for the outcome of the current situation. At issue then, just as it is now, was differentiating between the depressing influences that originated from the maladjustments in the preceding boom and the ill-advised policies that followed.

Among the German-speaking economists — Austrian, Swiss and German — who were strongly influenced by the Austrian school of economics promoted by such thinkers as Mises and von Hayek, it became the consensus view that the real causes of the particularly deep depressions in the United States and Germany had to be sought in the extraordinary financial excesses that occurred in the respective countries earlier in the 1920s. Booms and recessions were inseparable in their view. There were limits to unproductive and speculative borrowing, they believed. The crisis erupts at the point when the banking system's power of credit creation can no longer keep up with the continually increasing credit requirements of the over-extended economic system. Ultimately, the banks will have to defend their liquidity and once they begin to do so, a deflationary credit crunch is thrust into motion.

In America, economic thinkers took a different course. Professor Friedman's book, <u>Monetary History of the United States</u>, as a chronicle of the Depression has become the standard bearer of this American line of reasoning. His central conclusion was that the financial and economic collapse in the United States from 1929 to 1933 had nothing to do with the previous boom and was entirely attributable to the overly tight monetary policies of the Fed that followed. He summarized as follows: *"An initial mild decline in the money stock from 1929 to 1930, accompanying a decline in Federal Reserve credit outstanding, was converted in a sharp decline by a wave of bank failure beginning in late 1930."* In his way of thinking, it didn't make a difference whether one fell from the top rung on the ladder or the bottom one.

Mr. Friedman found the key cause and propagation of the Depression in the bank failures. His reasoning: *"The bank failures were the mechanism through which a drastic decline was produced in the stock of money."*

For Mr. Friedman, the preceding boom was irrelevant because, in his view, it had been free from any inflationary excesses. This he inferred from the fact that between 1923 and 1929 *"wholesale prices fell*

at a rate of 1% per year and the stock of money rose at the annual rate of 4% per year, which is roughly the rate required to match expansion of output."

All this led him to assert that the Depression could have been avoided if only the Fed had eased more aggressively. This sweeping judgement gave rise to two widespread myths among American economists: firstly, that low or absent price inflation is a sufficient safeguard against crises and depression; and secondly, that monetary policy has the power to avoid a depression whatever the circumstances.

It is precisely these myths that give rise to our cardinal dissent with the current complacency of the consensus. In our opinion, the vicious circle of debt and credit deflation that's currently hamstringing the world is primarily the legacy of the phenomenal debt and credit excesses of the 1980s.

The world economy has been building up exactly the same vulnerabilities as it did during the 1920s, only, at a much, much greater scale. In the 1920s, the United States was the only "bubble" economy spewing out asset inflation. This time, the world is riddled with countries that have caught this same disease — Japan, Britain, Canada, Australia and the Scandinavian countries. All in all, the 1980s were a period of unprecedented financial excesses.

THE UNWINDING OF AN ASSET INFLATION BOOM

Just as in the 1920s, the key propellant of the 1980s' boom was the inflation of asset values which allowed ever greater and reckless borrowing. Conversely, collapsing asset values are now the key mechanism driving the depression. It has taken years for the international asset boom to reach its peak; its unwinding will take years as well.

The unravelling process of an asset inflation bubble takes on a life of its own. As puffed up asset values deflate, companies and individuals caught in the net find themselves squeezed from three sides:

1. They can no longer generate cash flow — and easy profits — from either buying or selling assets. Their income is increasingly eaten up by sharply higher interest payments on their swollen debts.

2. Falling asset values force illiquid debtors into "distress selling." This causes asset prices to fall more.

3. As falling asset values wipe out the collateral values underpinning outstanding loans, losses suffered by the borrowers spread to the lenders — mainly the banks. As their capital bases shrink, banks have to restrain or shrink their lending. Lenders and borrowers deflate in lock-step manifesting itself primarily in a collapse of credit and broad money growth.

Given this outline of the deflationary process, a pertinent question begs: Really, how forceful and inevitable are these and other depressing influences stemming from the excesses and maladjustments of this past boom? What about the real estate crisis, the banking crisis, the widespread overindebtedness? Do they blunt the efficacy of monetary policy or don't they? Of course, they do.

THE EXCESSES THEN AND TODAY

It's important to get a sense of the enormity of the financial excesses of the 1980s. Just how do the

financial excesses of the 1980s compare in magnitude with those that led to the Great Depression?

Our answer in short: The financial and economic contortions of the 1980s compare horribly. The debt and leverage excesses of the 1980s by far surpass those of the 1920s. Let's review some key examples.

First, the stock market. In 1929, S&P industrial shares traded at an average of 18 times earnings and a dividend yield of 3%. Presently, the average price-earnings ratio is 29 and the dividend yield is 2.6%. But, that's not a complete comparison. In 1929, U.S. long-term corporate bonds were yielding only 4.4% — hardly much more than stocks — against today's rate of around 7.5%. Clearly, stock prices are much more inflated today.

Bank failures are another key measure. Most people are under the impression that the American banking crisis of the 1930s involved a far larger part of the banking system. This is simply not true. The statistic that's been popularized is that more than 9,000 banks failed in the four years from 1930 through 1933. A horrible number, yes, but with few exceptions, all of these were minute country banks.

Even though the number of banks was large, the losses produced by these failures were minor. Depositors, other creditors and bank shareholders suffered a total loss of $2.5 billion. Slightly more than half of this loss was borne by depositors. How large was that loss in relation to the total bank and savings deposits outstanding at the time? It was less than 3% of total existing deposits of about $55 billion.

How does the present U.S. banking crisis compare? At the end of 1989, total U.S. bank and thrift deposits totalled about $3.5 trillion. So far, savings and loans and bank bailouts have amounted to well over $200 billion. In addition, one must also consider the Federal Deposit Insurance Corporation's (FDIC) problem list of banks which totals another $613 billion of troubled deposits. Official estimates reckon total deposit losses from bank and thrift failures of at least $500 billion. That figure equals about 15% of total deposits . . . more than five times the deposit destruction of the entire Depression!

In terms of volume, clearly, the present banking crisis is much worse than that of the 1930s. Yet, mysteriously, very few worry about all this on the strength of the conviction that deposit insurance and unlimited government bailouts will take care of the financial system and depositors.

It's much too complacent a view. It conveniently ignores the other harmful side-effects of the vast capital destruction that is inherent in the asset deflation and the bank failures. It ignores the fact that these dynamics, even with the government bailouts, reduce the money supply. In the case of the bailouts, the government replaces the lost deposits with money that it borrows and thereby withdraws from the markets. In any case, the complacency ignores the fact that the slump in real estate values generally devastates the balance sheets of both debtors and their banks. It's only the depositors that are bailed out, and not the system.

THE IMBALANCES OF THEN AND TODAY

There is another critical aspect in the current situation which gets little attention or none at all. It concerns the existence of huge and chronic international savings imbalances and the related explosion of international indebtedness. Both are also reminiscent of the international developments in the 1920s. The difference is that the scale of the current folly surpasses anything that has happened before.

In the 1920s, Germany was the one big debtor country which ran a persistent current-account deficit of about 3% of GNP. Today, there are half a dozen major, chronic debtor countries that are hooked on an uninterrupted diet of large capital inflows. Seen over the last decade, the United States, Britain, Canada, Australia, Spain, and Italy were the recipients and Japan and Germany were the big creditors.

While the debtors and creditors may have changed places since the 1920s, one thing has not: the insane use of imported capital. Again, today, very little of the foreign loans financed productive investment. Instead of raising investment, the capital-importing countries — the Anglo nations in particular — experienced collapsing private savings, booming consumption, declining investment ratios and massive malinvestments primarily in real estate. Instead of raising internal capital formation (the building up of income-producing investments) these countries ravaged their capital structures both in terms of quantity and quality. As a result, they all have reduced their long-term growth potential.

Above all, with their persistent overborrowing abroad, these countries have literally crippled their manufacturing sectors. The basic process here is that the financial capital inflows, by pushing up the exchange rates, essentially squeezed the profits of the industrial sector. It's the industrial part of the economy, after all, which is directly exposed to foreign competition.

The great beneficiary of this kind of capital inflow is the consumer . . . at least for a while. His living standard rises because he can buy more goods for a given level of income. Capital inflows to a country represent a corresponding net increase in available resources. Unfortunately, in the long-run, many consumers become unemployed as a consequence of the profit squeeze on businesses.

THE ACHILLES' HEEL: INTERNATIONAL CAPITAL FLOWS

The amounts involved in this cross-border capital flow saga are staggering. In the United States, since 1982, the capital inflows and the corresponding current-account deficits have added to domestic resources by more than $900 billion, or almost 20% of current gross national product (GNP). In Canada, capital imports raised domestically available resources over this same period by $96.7 billion or 18.6% of GNP. It's not a net gain, we should point out, because it is partly offset by losses in domestic output. Over the long run, in any case, the resulting overconsumption, malinvestments and soaring foreign debt implies a progressive impoverishment. All of these dynamics are clearly exposed in the GNP and income statistics. Sadly, very few understand this chain of causation.

Another striking fact is that all the capital-importing countries belong to the category of the "bubble" economies. All of them have had rampant internal asset inflation, which, of course, is anything but accidental. While domestic asset prices were first driven up by the domestic credit inflation, the resulting asset inflation, in turn, increasingly pulled in foreign capital which further added to the speculative boom in securities and real estate. The inflationary drug, so to say, was administered at both ends.

A special case among the "bubble' economies is Japan. It is the one and only country with both a budget and a current-account surplus . . . and a very large one at that. In this respect, Japan's position resembles the situation of the United States in the 1920s. Those features didn't prevent the collapse of the U.S. economy then. Recently, economic data on Japan has turned outright gloomy.

What kind of stability can be found in this? It is the stability of a temporarily dormant volcano. As explained, these "bubble" countries have ravaged their long-term growth potential. Shockingly, despite

prolonged recession, they continue to run large and chronic current-account deficits which require permanently large capital inflows.

We have been wondering for some time who is still financing the large U.S. current-account deficit given that the U.S. securities markets have been weak and that U.S. interest rates are at three-decade lows. Once again, it's the central banks that have stepped in. Treasury securities — bills, notes and bonds — held by the Federal Reserve on behalf of foreign central banks have leaped by $38 billion this year, about $17 billion alone in the last two months. The total holdings of foreign central banks now amount to almost $300 billion.

The foreign indebtedness of the "bubble" economies is already at levels that was unthinkable only a few years ago. And that raises another point of contrast with the 1920s. Then, most of the international borrowing excesses took the form of bank lending. Today, it is taking place more through the tradeable securities markets. Capital mobility has increased. For us, that's a house of cards waiting for a panic-driven collapse.

A LIKELY EPILOGUE

The handwriting is clearly on the wall. Evidently, the international lending and borrowing binge of the 1980s could simply not go on at that hectic pace. Already, a dramatic reversal has taken place. Banks — the Japanese banks in particular — have been slashing both their international interbank credits and their lending to non-banks. Between 1985 and 1990, international bank lending to non-bank customers grew by an average of $290 billion a year. Last year, it slowed abruptly to $85 billion. The downtrend continues. Cross-border interbank credits contracted in the first quarter of 1992 by $81 billion.

One more word about the great sophistication of today's policymakers and economists. We already mentioned the stock price inflation of the 1920s. Then, the Fed was deeply worried by it. As well, the German central bank under Herr Schacht was very worried about the rising tide of foreign debt and tried to stem it. They knew that it would spell disaster eventually.

Today, there's a nonchalant complacency about everything. Anything goes, economically speaking. The experts have concluded that stock price inflation, a real estate and banking crisis and permanently large budget and trade deficits don't matter . . . neither today or tomorrow. All of these issues are swept under the carpet with the catchwords of "diversification," "globalization" and a "new era." A need for diversification apparently transcends prudence no matter how bankrupt a country may be. We aren't surprised that it is these same experts that are announcing one false recovery forecast after another.

We doubt that the governments and the central banks can do very much about the deepening worldwide economic and financial crisis, even if they knew better. The grave tragedy is that they don't know better. Just as they never understood the sinister workings of asset inflation in the first place, they can't be expected to understand the wide-spread implications of asset deflation either.

CATCHING UP WITH THE MARKETS

Currencies, bonds, stocks, and gold have all been reactive recently. The key question for them, to start with, is the state of the world economy. We see spreading economic sluggishness and worsening asset deflation. Most significant to us, as we have often stressed, is the persistent and unusual weakness in

private credit and the related broad money growth. The unpalatable fact is that these monetary trends are worsening, not improving.

In the United States, Japan and Britain, broad money growth has now fallen below nominal GNP growth for the first time. That bodes ill, particularly for their asset markets, thus signalling still worsening asset deflation.

We fail to see how both businesses and consumers can reliquefy as a whole under these conditions. True, they are retrenching, but at the same time, their incomes and the value of their assets are shrinking — home equity, particularly, is the most important part. It is a desperate race between spending retrenchment and wealth and income losses, one driving the other. The consumer, we are sure, will not pull these economies out of recession.

CURRENT TRENDS OUTSIDE OF THE ANGLO COUNTRIES

The focus is presently on Europe, both for economic and currency reasons. So far, the Continental European economies have held up best among the industrial countries, helped greatly, of course, by the big demand boost from German unification which has since flattened out.

What's still affecting Europe at full force is Germany's high interest rates. They're increasingly taking a toll on European economies, currencies, and stock and bond markets. For most countries and Europe as a whole, GNP growth, though turning weaker, is still positive. However, the situation is rapidly deteriorating. The manufacturing sectors are showing the greatest weakness.

European governments have decided to maintain unchanged parities against the D-mark despite the financial turmoils and inflationary strains resulting from German unification. In the last analysis, they have accepted the monetary constraint which this implies in the hope that it would increase the credibility of their long-run commitment to price stability and lower long-term interest rates over the long-run. In this respect, their restraint is self-imposed. Spectacular victims of these developments, aside from the shellacking that the high-yielding bond markets received earlier, are Europe's stock markets. All of them have experienced severe beatings since early June — declines ranging from 18.6% in France to as much as 28% in Italy.

Meanwhile, the triple combination of a weak dollar, a strong D-mark and growing doubts over the ratification of the Maastricht treaty is heightening tension within the European Community's (EC) exchange rate mechanism (ERM). It's an open secret that the Bundesbank thinks that an exchange rate realignment is both necessary and desirable. All the exuberant talk about convergence in inflation rates between the EC countries doesn't obviate the fact that since the last ERM realignment in 1987, national inflation rates have diverged drastically. Cumulative inflation since then has amounted to 16% in Germany (more than half of it occurring in the last two years), 33.3% in Italy, 33.1% in Spain, 70.9% in Portugal and 35.9% in Britain.

Much praise has been heaped on the ERM system because of its achievements in exchange rate stability. But, too much rigidity can be just as damaging as too much volatility. Basically, we are in favour of fixed exchange rates. But, the problem is that during the 1980s, markets completely perverted the currency system. Normally, currency markets have exerted a disciplinary influence on governments. Rising current-account deficits, for example, were looked upon as indicators of inflation and triggered capital

flight. That vigilance of the currency markets forced the deficit countries to adjust early in the game. It was virtually impossible to have persistently large current-account deficits.

This former disciplining of government by the currency markets was turned completely upside down in the 1980s. Bankers, investors, and markets became tolerant of current-account deficits as never before. Neglecting current-account deficits, budget deficits, exchange-rate risks and divergent inflation rates, international investors simply and blindly chased after the highest nominal interest rates. As the highest rates were offered by the countries with the highest deficits and inflation rates, they attracted the big capital flows which turned the currencies with weak fundamentals into the strongest performers and the hard currencies into castaways. Thus, the highly inflationary Spanish peseta and the Portuguese escudo were tops and the D-mark trailed at the bottom of the heap. As such, we've always had our reservations about the ERM and advised against investing in the high-yielding currencies.

Remarkably, this reckless game wasn't just confined to the fixed exchange rates of the ERM system. It also affected the floating currencies. The Anglo "bubble" economies, in particular, attracted a wildly overproportioned share of foreign capital. The short-term gains from investing in these currencies have been considerable. Inevitably, these gains are destined to disappear in asset deflation and sliding currencies. Bear in mind the destructive effects that these excessive capital imports had on the warp and woof of these countries in the first place.

We have always warned that the day of reckoning for the currency markets — particularly for the currencies of the capital-importing countries whether in Europe or elsewhere — will come when their economies weaken and domestic policies begin to clash increasingly with external requirements. In Europe, a number of countries including Sweden, Finland and Italy already have had to raise their interest rates to defend their currencies. As weakening economies will probably further heighten currency tensions, other countries, including Britain, will have to follow suit. Just as in the 1930s, the general slogan is to deflate rather than devalue.

The United States remains the main exception; its short-term interest rates have been slashed to incredible lows. But all this easing has yet to help. Yet, most people are astonished over the spectacular dollar weakness recently (the dollar hit an all-time low against the D-mark of DM 1.3950). The basic reason for that, in our view, is the false optimism about an imminent U.S. recovery. Every random up-tick in the economic or monetary data is seized upon as proof of a nascent recovery.

If one is focusing on the trend of the fundamentals, one can only conclude that the U.S. recession is deepening. A continuing slump in private credit and broad money, business profits, real incomes (excluding government transfers), and asset values are just some of these fundamental indicators. To think, as the popular theory goes, that slow growth is beneficial because it lowers inflation and interest rates, is foolishness. If incomes slow faster than debt growth and asset values, then the economy will be caught in a deflationary trap. That's exactly the pattern in all of the "bubble" economies.

CONCLUSIONS

Most forecasters continue to crank out their "dream merchant" recovery forecasts. However, the fundamental trends we see in the economic data speak unambiguously of a deepening world recession.

Stocks should be avoided above all. The worldwide profit picture, although uneven, is eroding abysmally.

We remain most sceptical of the stock markets in the "bubble" economies — most particularly, the overvalued U.S. market.

Europe's stock markets, having capitulated to the fact that German interest rates are staying high, have already fallen off savagely. Meanwhile, a further rise in interest rates has become less probable due to the extreme weakness of the dollar — which lowers German inflation — and a weakening economy. The prospect of lower interest rates may temporarily boost these stock markets, but, it has yet to dawn on most investors that economic weakness and falling profits are here to stay.

The next great watershed for markets is the French referendum on Maastricht, slated for September 20th. We fervently hope that the French voters will spare us from this insane script for monetary unification that was crafted by the arrogant Euro politicians. A French "non" would clean the air once and for all. If not, we think that the financial strains of the 1990s will make the establishment of a common currency in Europe highly improbable anyway. Either way, it will boost the D-mark, paving the way for lower German interest rates. Long-term rates in the weaker currencies, though, may well rise.

Seen from a global perspective, the American, Australian, and Canadian dollars remain locked in long-term bear markets. Short-term counter rallies shouldn't be ruled out from time to time. Clearly, fundamentals are again ruling the currency markets.

For long-term investors, government bonds in hard currencies — we recommend the D-mark and Swiss Franc — are the best refuge. Their high quality, attractive yield and fundamentally strong currency denomination recommend them. And, as long-term rates begin to decline, they can be expected to appreciate, too.

(Editor's Note: We get numerous inquiries from our subscribers outside of Europe seeking advice on how and where to buy hard currency bonds. Currencies and Credit Markets prefers to remain impartial. Should subscribers need assistance, we are preparing a short list of financial institutions that could be contacted. It will be available in mid-September and can be requested from the Subscription and Administration Office.)

Next Mailing: October 7, 1992

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Mendelssohn Strasse 51, D-6000 Frankfurt 1, GERMANY. TELEPHONE: 49-69-746908 FAX: 49-69-752583

Subscription and Administration Inquiries: Mulberry Press Inc. 7889 Sixteen Rd., Caistor Centre, Ontario, CANADA, L0R 1E0. TELEPHONE: 416-957-0602 FAX: 416-957-0602.

Annual Subscription Rates: 12 Issues. Europe: DM 600.00. Subscribers outside of Europe: $US 400.00